

Insurance in Distressed Financial Times

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**How to Handle Defaults, Distress, Maturities,
and Stacks of Debt**

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Commercial and residential lenders enter into loans with the idea of forming a partnership with their borrowers. The borrower owns real estate and the lender collects interest for their lien interest in the secured real estate. When, as in the last two years, the financial backing that gives value to these real estate assets becomes weakened, the value of the real estate asset diminishes. Another factor that affects the loan is the perceived value of assets. Since 2002 real estate assets from condominiums to high rise office towers experienced a frenzy of buying to the extent that perceived value was higher than actual value. In many areas, most notably Florida and its condominium market, over building occurred, which resulted in a glut of the commodity with few or no buyers. This was followed by a stock market and financial system near collapse in 2008. The result was a sharp decrease in values to the point that many owners now find themselves with higher mortgage debt than the asset is worth. This was further complicated by a mortgage market that loaned up to 100% of the inflated asset value and many times to borrowers who would not be qualified in a tight underwriting environment.

So is it any surprise that owners are cutting back on expenses in every area, insurance being one of them?

Loan Servicing

In a normal real estate market, the servicer's monitoring of borrower's compliance with insurance requirements as contained in the lending agreement is of the utmost importance. If a casualty damages an asset and its earning power, the insurance policy is expected to respond to smooth out cash flow and restore the asset. In these trying financial times investors in real estate are monitoring and closely evaluating operating expenses. One prime target for expense reduction is insurance cost which may result in a reduction of coverage. Evidences of insurance should be closely monitored for reductions in coverage and limits as follows:

- Insuring a property for less than its full Replacement Cost Value (lower values = lower premium). Not the way to reduce cost and likely a violation of the policy terms and conditions.
- Elimination or reduction of required insurance endorsements: Business Income; Rental Income; Extended Period of Indemnity (of significant importance when

tenants vacate their lease following a loss); Flood and Earthquake (reduction or dilution of limits); Boiler & Machinery; reduction of Liability Limits and types of coverage and many others.

- Change in insurers should warrant a closer review of the quality of coverage but also the quality of insurer. Oftentimes accepting a bid from a new insurer with an inferior AM Best or S&P rating may not be in compliance with the lenders minimum requirements or rating agency standards.
- Change of insurers can also signal the use of an excess lines insurer. These insurers may be acceptable; however, they generally do not use standard industry forms. Thus the protections afforded by generally accepted industry forms, such as the Standard Mortgagee Endorsement, may not be provided.

The right way to trim insurance cost is by conducting a professionally managed competitive bidding effort. This bidding effort should be conducted by either an internal risk manager or outside risk management consultant who has no interest in selling you insurance. This process includes the selection of qualified brokers capable of delivering services needed by the insured, allocation of markets possessing strong financial positions among the selected brokers, preparation of comprehensive coverage specifications that fit the risk exposures and contingencies of the insured, followed by careful evaluation of proposals and awarding of the placement. This process results in true market responsive coverage and pricing results.

Property in Technical Default

Long before a property is foreclosed by a lender there is usually a period where the borrower is not in compliance with the requirements of the lending agreements. It is usually at this point that a close review of the borrower's insurance program for the asset should be conducted.

In these pre-default situations, where the title of the property remains with the borrower, it is important that the lender make sure that the borrower's insurance is appropriate for the property, in compliance with the loan document, and is fully paid for. A work-out situation should trigger an internal requirement to do a thorough insurance check up. This may be simply an internal review of the certificates of insurance on file to make sure they are

current and meet the terms of the loan document, or if something seems awry, a detailed review by a professional consultant.

A pre-default situation or possible foreclosure should also trigger a request for complete copies of the current insurance policies from the borrower. Once received, these policies should be reviewed for compliance with loan agreements and be sure that the lender's interests, such as Mortgagee and Additional Insured, are properly documented and that required coverage levels are maintained.

Premium Finance Agreements

Another important issue to look into during the pre-default period is to determine if the borrower has used a premium finance company to pay the premium to the insurer. A premium finance agreement is used when an insurer wants the full premium at policy inception and the insured may want to spread the payments out over the policy term. In this case a finance company will agree to pay the insurers the entire premium for the policy(ies) up front, and the borrower will have to repay the advanced monies, usually a 30% deposit followed by 9 monthly payments. When a premium is financed the finance company has powers over cancellation of the policy, should payments be late. This introduction of another party between the insurer, insured and lender should be looked at as a loss of control.

Should the premium not be paid on time the finance company will send notice of cancellation with 10 days notice. Cancellation is sent to the first named insured and, for property insurance, to any mortgagee listed in the finance agreement. If the policy is a general liability policy notice is not generally sent to the mortgagee.

When All Else Fails: Foreclosure

As more lenders find themselves in the position of owning, through foreclosure, properties and unfinished construction projects they are being required to address the issue of insurance continuity.

When confronted with a foreclosure, many attorneys and lenders work under the impression that the insurance in place for the property can be automatically "assigned" to the new owner entity created by the lender. This is a false assumption that could delay obtaining replacement coverage and cause timing problems for the lender.

A standard property insurance policy will contain a clause that prohibits policy assignment without prior approval of the insurance company. So while in theory, a policy assignment may be possible, as a practical matter, the assignment must be accepted in advance by the insurer. Another issue to remember is that the insurance company considers a change in ownership a material change of the risk, a situation that allows them to cancel the policy.

Assignment will likely be successful where a property is insured by a single insurance policy specific for the property versus those that are insured in multiple locations with different interests. In the circumstance where multiple properties are insured in one policy, underwriters may agree to provide a stand alone policy for the foreclosed property. In any case the insurers must be approached and agree to provide coverage for the new owner.

Caution: If an insurance company underwrote this property because they write other properties for that insured, your specific property may not, on a stand alone basis, qualify under the current insurer's underwriting standards.

As an alternative to an assignment, underwriters may agree to cancel and rewrite the policy. In a cancel and rewrite situation, underwriters may re-price the policy and may not offer the same coverage, terms and conditions. In a cancel and rewrite, the return premium for the unused portion of the policy will go back to the first named insured, and the new entity will be charged the entire new premium for the replacement policy.

From the perspective of the insurance company, the only contract that governs the relationship between them and the named insured is the insurance policy. The insurance company is not a party to any agreement between the borrower and the lender. As a result, they may not have to abide by any of these other agreements.

It is a very common scenario that loan proceeds may have been used to pay the original policy premium, or in the pre-default process, the lender may have even agreed to pay the premium directly to insurers. If a policy is cancelled and there is a return premium, it is the first named insured that is named on the check, so get assignment of return premiums in the foreclosure. While the lender may be correct in asserting that they are entitled to the return premium, unless there is an agreement in place to address this issue the lender may have a difficult time recovering these funds.

In general the insurance company is going to do the following for you with regard to the existing policy:

- Agree or not agree to provide replacement or continuing coverage.
- If they agree to continuation of coverage, will it be assignment of the same policy, or a new policy, a so called “cancel rewrite?”
- You need to ask if there will be any changes in the policy coverage, terms and conditions.
- Determine who is entitled to the return premium.

Sources of Insurance in Foreclosure

If the lender finds itself in the position of having to obtain coverage on its own for this property, then there is a process that needs to be undertaken. The lender should review the following sources for obtaining coverage.

In-House Program - does the lender have an in-house Owned Real Estate (ORE) resource that can provide the necessary insurance? Many residential and small commercial lenders have arrangements with insurers to provide coverage for properties that are either in default (In Substantive Foreclosure: ISF) or fall into foreclosure (ORE). Depending on its structure, it may include coverage for all properties that are foreclosed automatically, or the insurer may require that values and locations be reported before, or within a certain time period for coverage to attach. When ORE or ISF programs are not in place stand alone insurance coverage will need to be marketed and obtained. Stand alone insurance is usually needed for large commercial loans, construction projects or vacant properties.

In a foreclosure where a large loan has a secondary or Mezzanine lender, the secondary lender may take ownership and become the borrower. In this case the primary or first mortgage holder’s loan becomes the obligation of the secondary lender and the secondary lender is responsible to purchase the insurance.

If you are hiring a real estate management company to manage the property they may have an insurance program that you can access. Some larger management companies have blanket programs that afford good levels of coverage for properties that they manage at competitive pricing.

In cases where a property requires replacement insurance coverage, the lender is faced with approaching the insurance market place. This process can be formidable for the novice insurance buyer. Use of the lender's internal risk manager, lender's corporate insurance broker or an independent risk management consultant can make the process faster and more effective.

It is important to keep in mind that you will need both property insurance to protect against first party damage, for example, fire and so called All Risk perils, and liability insurance which will protect the ownership entity from third party liability suits for bodily injury and property damage. We have noted below a summary of the information you will need to proceed with obtaining a stand alone policy.

- Exact name of the new ownership
- Full address, including zip code
- A description of the building - For example, "A 32 story, 375,000 sq.ft. Class A office building constructed of reinforced concrete, located in Stamford, Connecticut."
- Known Loss Information - A three to five year history is usually required
- The insurable values for the building (replacement cost value) and business income (12 months)
- Occupancy details
- Description of the area around the building. These are exposures that could subject your property to an increased risk of loss.
- Is the building fully occupied? If the building is vacant, this will give rise to many other underwriting questions, as well as impact the number of insurance companies that would be willing to provide coverage.

The above represents a somewhat detailed outline of some of the data that is necessary to obtain an insurance quotation, but it is not exhaustive. Consult with your insurance and risk management advisor, as that professional will be able to advise you on what information is needed to obtain the necessary coverage and they will also be able to ensure that the quotations received contain the appropriate coverages for the building or project.

Issues Regarding Construction Liability Insurance

In a non-construction foreclosure, the liability insurance placement is relatively straight forward. However, if the foreclosure is on a project that is under construction, then the liability insurance becomes a significantly more complicated issue.

Most large construction projects are covered by what is called an Owner Controlled or Contractor Controlled Insurance Program (OCIP or CCIP). In order to understand some of the issues that these programs bring to the surface in a foreclosure, we need to explain some background on how they work and how they are structured.

The concept behind an OCIP or CCIP, (for convenience we will call them a CIP), is that all contractor and sub-contractor liability and workers compensation insurance for a given project is insured in one place. This means that a single liability insurance policy and a single Workers Compensation policy provides coverage for all parties working at a construction site. This insurance program provides insurance for the general contractor and all of the sub-contractors that work at the sight. Consolidation of the insurance program gives the owner opportunity to reduce cost through economy of scale purchasing power and by sharing in the loss cost through a retrospectively rated insurance program that gives the owner return of a portion of the premium if losses are less than originally forecasted.

Example: The named insured, either the owner or general contractor (GC) agrees to pay a given amount of each claim that occurs, the deductible. This is usually \$250,000 for each workers compensation claim and \$500,000 for each general liability claim. The insured will receive a discounted premium for taking these deductibles, with the assumption that losses within the deductibles will handle most of the claim activity on the project. The amount of premium subject to losses within these deductibles could be 50% to 70% of the total premium for the liability and workers compensation.

The insured (owner or GC) is responsible to pay each claim and the associated loss adjustment expense up to the deductible. The liability of the owner or GC for loss payments within the deductibles are secured by cash deposits into an escrow account and either letters of credit or other acceptable security for the program's maximum aggregate liability for all losses. This fund is replenished from time to time depending on loss activity.

So what issues do we need to consider when foreclosing on a construction project? The first would be to determine who is responsible to pay the claims under the CIP going forward. Please keep in mind that it would not be unusual for a construction project in a major metropolitan area to end up with well over \$2,000,000 in claims paid under the deductible. Collateral and escrow funds could be many millions, depending on the size of the project.

If you are foreclosing while the CIP is still active, your new ownership entity needs to be covered under that CIP or have an owner's liability insurance program. You should also assume in either an OCIP or CCIP that you will likely become responsible for claims payments under the loss sensitive CIP program.

A word on the collateral: If the insured had posted collateral in the form of a letter of credit, then you may be responsible to replace that letter of credit. If the insured posted cash as collateral, then you have to see who has rights to those funds. If the lender provided the funds that the borrower used to pay the collateral, then you would think the lender would be entitled to obtain the refund of the collateral once the program has been closed out. This may not be the case if the lender is not part of the security document that controls the financing of the CIP.

Probably the largest issue that can complicate the foreclosure is if the project you are foreclosing on is covered under a CIP that also covers other projects, a so called "Rolling Wrap-up". If this is the case, then the claim payment and collateral issues are much more difficult to sort out.

For a multiple project CIP, there will probably be only one loss fund account, so it will be critical to be able to make sure that your project is not being charged for losses that belong to another project. Likewise there will only be one collateral account. If it is cash collateral, "ownership" of the collateral funds is harder to discern, since the funds are comingled.

It may be that the best solution is to split your project off the multiple project CIP and place it in a separate insurance program. This process will take some time and skilled negotiation to complete, and will likely result in increased cost for the insurance. Also any changes made to an existing program are likely to increase the premium.

Keep in mind also that the CIP also covers Products and Completed Operations. This coverage is intended to handle any future claims for liability emanating from the completed work after completion. Products and Completed Operations coverage is usually provided with a claim reporting tail for a given number of years in which liability for property damage and bodily injury claims could be made.

When reviewing all of these issues, remember that as the lender you were not a party to the contracts between the insurance company and the borrower, which spell out the terms of the CIP. So while you may be able to enter into a separate formal contract or agreement with your borrower on how you will handle these many issues, if you do not include the insurance company into the discussions, you may find that the insurance company is not going to abide by the terms of this separate contract or agreement.

If you are in a situation where you are foreclosing on an active or recently completed construction project, it is critically important for you to retain the assistance of an experienced risk management and insurance consultant able to provide you with significant guidance as you work your way through this process. The situations are all unique, and there are not necessarily any simple straight forward solutions for a foreclosure on a construction project.

Construction Bonds

In foreclosure of a construction project, the importance of good pre-foreclosure bond administration cannot be understated. Bonding requirements from lenders should require that all contractors include as Obligees the contracting parties and, in addition to the GC and owner, the lenders. This goes hand in hand with being assigned the construction contracts if the GC or owner defaults. If the lender is not named as Obligee and forecloses on a project they may not have recourse to the Surety in the event of default by the contractor.

This problem does not go away if the project is complete. A contractor may have a warrantee period for a year or two following completion that can be covered for performance failure. If the lender does not have assignment of the construction contracts and multiple Obligee Endorsements to the bond, the lender will find itself in a difficult and costly situation.

Conclusion

The process of managing the various insurance issues that arise when dealing with properties that are in some form of distress can be a time consuming and complicated matter. Through this article we have tried to highlight some of the potential issues and provide a general outline for their successful handling. This is done with the understanding that each situation is unique and requires specific individual attention to ensure that the various issues are settled adequately. Obtaining the assistance of an insurance professional to aid you in the process is a critical tool to help the process come to a successful conclusion.

About the Authors

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Mr. Branigan is President and CEO of Omega Risk Management LLC, which provides insurance consulting services to corporations and conducts due diligence reviews for financial institutions originating large commercial and construction loans throughout the United States and Canada.

Mr. Branigan has written several papers on insurance in real estate finance for the Practising Law Institute (PLI) and co-authored a chapter on insurance in the Commercial Leasing Book published by the New York State Bar Association in 2004. He co-authored a Model Loan Document for Commercial Real Estate Transactions that has been widely published in trade and legal publications nationally. He has served on the PLI Faculty for eight years, has been a speaker at the New York Bar Committee on Leasing, and was a panelist on insurance in commercial leasing for the New York City Dirt Lawyers. He has made presentations on terrorist insurance before the New York State Bar Association-Real Property Section annual meeting (January 2002) and the Texas Bar Advance CLE Seminar (July 2002). Mr. Branigan has delivered numerous insurance training sessions for commercial lenders, the Real Estate Lenders Association, and law firms throughout the U.S.

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Mr. Bischoff has been in the insurance industry for 25 years. Prior to joining Omega he was Senior Vice President of a mid-sized, internationally recognized insurance brokerage firm. During this time he handled the insurance and risk management needs of multi-national firms.

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About Omega Risk Management LLC

Omega Risk Management, an independent, full-service insurance and risk management consulting firm, has been delivering cost-effective services to clients throughout the United States and internationally since 2001. Omega Risk Management provides insurance and risk management advice to real estate, investment banking, and commercial and industrial companies in North America and Europe and guides its clients through the complexities of insurance-related issues in an ever-evolving and competitive marketplace. Omega Risk Management LLC is a National Première Sponsor of the Real Estate Lenders Association. For more information, visit www.OmegaRM.com.